

STATE OF NEW YORK

DIVISION OF TAX APPEALS

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In the Matter of the Petition	:	
of	:	
<b>FO-NA, INC.</b>	:	DETERMINATION
	:	DTA NO. 819995
for Redetermination of Deficiencies or for Refund of New	:	
York State Personal Income Tax under Article 22 of the	:	
Tax Law for the Years 1999, 2000 and 2001.	:	

Petitioner, FO-NA, Inc., 265 Post Avenue, Suite 320, Westbury, New York 11590, filed a petition for redetermination of deficiencies or for refund of New York State personal income tax under Article 22 of the Tax Law for the years 1999, 2000 and 2001.

A small claims hearing was held before James Hoefer, Presiding Officer, at the offices of the Division of Tax Appeals, 400 Oak Street, Garden City, New York on October 22, 2004 at 9:15 A.M. Petitioner appeared by Jaeckle, Kearney & Lepselter, CPA's, P.C. (John J. Kearney, CPA). The Division of Taxation appeared by Christopher C. O'Brien, Esq. (Luciene Wright).

Since neither party herein elected to file a post hearing brief, the three-month period for the issuance of this determination commenced as of the date the hearing was held.

***ISSUE***

Whether petitioner was required to withhold and remit New York State income taxes from the compensation it paid to its four officers for the years 1999, 2000 and 2001 and, if so required, whether it is liable for payment of interest and penalty for its failure to withhold and remit said taxes.

***FINDINGS OF FACT***

1. Petitioner herein, FO-NA, Inc., was incorporated in New York State, and for each of the three years at issue, it elected to be treated as an S corporation. It is undisputed that petitioner maintained an office in New York and was required to withhold and remit New York State income taxes from the wages paid to its employees for the years 1999, 2000 and 2001.

2. For the years at issue, petitioner had four officers who were also shareholders and employees (“officer/shareholder”). Petitioner, in addition to the four officer/shareholders, also employed four to five other individuals. Petitioner did not withhold any New York State income taxes from the compensation it paid to its officer/shareholders; however, it properly withheld and timely remitted New York State income taxes from the wages paid to nonofficer employees. The following table sets forth the compensation paid by petitioner to both officer/shareholders and nonofficer employees for each year in dispute:

	<b>1999</b>	<b>2000</b>	<b>2001</b>
Wages paid to officers	\$624,000.00	\$576,000.00	\$728,000.00
Wages paid to nonofficers	9,225.00	75,887.00	116,821.00
Total wages paid	\$633,225.00	\$651,887.00	\$844,821.00

3. In 1998 petitioner sold a substantial portion of its business assets and said sale produced a significant capital gain for each of the four officer/shareholders. Petitioner’s accountant and representative, who is also the accountant and tax preparer for each of the four officer/shareholders, recognized that each officer/shareholder would have a sizeable New York State income tax liability for 1998, and therefore he had each officer/shareholder pay a significant sum into his respective estimated tax account for 1998. Upon preparation of each officer/shareholder’s 1998 New York State personal income tax return it was found that each

officer/shareholder had grossly overpaid his tax liability for 1998 and that each had overpayments for 1998 ranging from \$30,000.00 to \$50,000.00.

4. At the time that each officer/shareholder's 1998 personal income tax return was prepared, discussion occurred between the officer/shareholders and the accountant concerning what to do with the large overpayments shown on their 1998 personal income tax returns. It was decided by all four officer/shareholders that instead of having the overpayments refunded to them, they would apply their respective overpayments from 1998 to their 1999 estimated tax accounts. When each officer/shareholder's 1999 personal income tax return was prepared, the overpayment from 1998, which was applied to 1999, was sufficient to pay the liability for 1999 and still produce an overpayment. As was the case for 1998, each officer/shareholder elected to apply the 1999 overpayment to his 2000 estimated tax account. This exact same scenario also occurred for each officer/shareholder for the 2000 and 2001 tax years. In fact, as the result of the overpayment from 1998 each officer/shareholder still had an overpayment on his 2001 tax return which each elected to be carried over to his 2002 estimated tax account.

5. Since each officer/shareholder had prepaid his 1999, 2000 and 2001 New York State personal income tax liability by applying the overpayment from the previous year's tax return to the following year's estimated tax account, they directed petitioner not to withhold any New York State income tax from their wages for said years.

6. The Division of Taxation ("Division") conducted a field audit of petitioner's books and records for the years 1999, 2000 and 2001 to determine if it had collected and remitted the proper New York State income taxes from its employees' wages. After reviewing petitioner's withholding tax records, the Division concluded that petitioner was required by law to withhold New York State income taxes from the wages it paid to its four officer/shareholders.

7. Although it is undisputed that petitioner failed to withhold taxes from officer/shareholders' wages, the Division found that petitioner, pursuant to Tax Law § 676, was relieved from liability for any taxes due since it had been established that its officer/shareholders had paid all taxes due. The Division also concluded that Tax Law § 676 did not relieve petitioner from liability for any interest and penalty due based on its failure to deduct and withhold taxes from the officer/shareholders' wages.

8. On February 18, 2003, the Division issued three notices of deficiency to petitioner, one for each of the years 1999, 2000 and 2001, asserting that interest and penalty<sup>1</sup> were due on the amount of New York State income taxes petitioner failed to deduct and withhold from the wages paid to its officer/shareholders. The following chart sets forth the amount of interest and penalty asserted due by the Division:

	<b>1999</b>	<b>2000</b>	<b>2001</b>
Interest	\$3,205.33	\$2,999.96	\$1,331.75
Penalty	3,727.22	3,448.59	-0-
Total	\$6,932.55	\$6,448.55	\$1,331.75

***SUMMARY OF THE PARTIES' POSITION***

9. Petitioner argues that its failure to deduct and withhold New York State income taxes from its officer/shareholders' wages was not willful or due to negligence or intentional disregard of the Tax Law, and thus it was improper for the Division to assess penalty. Initially, petitioner notes that its four officer/shareholders made timely payments to their 1998 estimated tax accounts in amounts sufficient to cover the taxes due for 1998 and still produce overpayments for 1998 which exceeded the taxes due for 1999, 2000 and 2001. Petitioner also

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<sup>1</sup> The record herein does not disclose what penalty or penalties were asserted due and why no penalty or penalties were assessed for the 2001 tax year.

argues that it properly collected income taxes from all nonofficer employees and timely filed withholding tax returns remitting full payment of the taxes withheld. It is petitioner's position that the corporation and its four officer/shareholders were essentially one and the same; that the corporation was keenly aware of the fact that the officer/shareholders had substantial overpayments on their 1998 personal income tax returns which were carried forward to 1999, 2000 and 2001 and completely and fully satisfied their income tax liabilities for said years; and that the Division's position is one of form over substance since had each officer/shareholder merely filed the proper withholding tax exemption form (Forms IT-2104 or IT- 2104E), this controversy would have never occurred.

10. With respect to interest, petitioner asserts that it is unfair and inequitable for the Division to assess interest since its officer/shareholders had made substantial timely estimated tax payments. Petitioner maintains that the Division had the use of the funds and the fact that said funds were in the officer/shareholders' estimated tax account instead of the corporation's withholding tax account is of little importance. Petitioner questions in its petition "how can the state ask for interest since they have already received the tax before it would have needed to be withheld?"

11. The Division maintains that petitioner and the officer/shareholders are separate and distinct taxpaying entities and the fact that the officer/shareholders made estimated tax payments to satisfy their individual personal income tax liabilities for 1999, 2000 and 2001 has no bearing or effect on petitioner's responsibility under the Tax Law to deduct and remit taxes from the wages paid to its employees.

### ***CONCLUSIONS OF LAW***

A. Pursuant to Tax Law § 671(a)(1) petitioner, as an employer, was required to deduct and withhold from the wages paid to its employees “an amount substantially equivalent to the tax reasonably estimated to be due. . . .” In the instant matter, it is undisputed that petitioner failed to deduct and withhold any taxes from the wages it paid to the officer/shareholders. In such circumstances, Tax Law § 676 provides that:

If an employer fails to deduct and withhold tax as required, and thereafter the tax against which such tax may be credited is paid, the tax so required to be deducted and withheld shall not be collected from the employer, but the employer shall not be relieved from liability for any penalties, interest, or additions to the tax otherwise applicable in respect to such failure to deduct and withhold.

B. Addressing the penalty issue first, petitioner has established that its failure to deduct and withhold taxes from the wages paid to its officer/shareholders was not willful or due to negligence or intentional disregard of the Tax Law. Although an employer is a separate entity from its employees, in this case, petitioner, the employer, was fully aware that its four officer/shareholders had made timely and adequate estimated tax payments. Moreover, petitioner properly withheld and timely remitted the tax deducted from nonofficer wages, thus establishing a good faith intention and effort to comply with the Tax Law as it relates to withholding taxes. Given the facts of this case, it was reasonable for petitioner to acquiesce to the requests of its officer/shareholders to not withhold any income taxes from the compensation paid to them. Accordingly, the penalty or penalties imposed herein are canceled.

C. With respect to interest, Tax Law § 684(a) provides as follows:

If any amount of income tax is not paid on or before the last date prescribed in this article for payment, interest on such amount . . . shall be paid for the period from such last date to the date paid, whether or not any extension of time for payment was granted.

Careful examination of the record leads me to the conclusion that, in this situation, the Division's assertion of interest is unfair and inequitable (Tax Law § 2012). Although petitioner did not collect and remit withholding taxes on the officer/shareholders' wages on or before the last date prescribed by statute, it must be noted that each officer/shareholder made substantial estimated tax payments in 1998 which in effect prepaid his income tax liabilities for the 1999, 2000 and 2001 tax years. The Division argues that petitioner and the officer/shareholders are separate entities and should be treated as such; however, given the particular circumstances of this matter, there is no reasonable justification for a complete separation of the corporation and its four officer/shareholders.

D. Estimated tax payments are the functional equivalent of withholding tax payments; both are means by which taxpayers can prepay their income taxes. Accordingly, it follows that where an employee prepays his income taxes via estimated tax payments rather than having tax withheld by the employer, interest on the employer's failure to withhold and pay over tax must stop as of the date of the employee's estimated tax payments. The fact that the tax was prepaid through the officer/shareholders' estimated tax account and not petitioner's withholding tax account is a form over substance distinction that, given the facts herein, should be accorded little weight.

E. The Tribunal, in *Matter of Rizzo* (Tax Appeals Tribunal, May 13, 1993), has described interest in the following manner:

Failure to remit tax gives the taxpayer the use of funds which do not belong to him or her, and deprives the State of funds which belong to it. Interest is imposed on outstanding amounts of tax due to compensate the State for its inability to use the funds and to encourage timely remittance of tax due. . . . It is not proper to describe interest as substantial prejudice, as it is applied to all taxpayers who fail to remit . . . tax due in a timely manner. Rather, a more accurate interpretation would be to say that interest represents the cost to the taxpayer for the use of the funds. . . .

It is noted that to sanction the result urged by the Division and allow interest to be charged would, in effect, permit the Division to collect interest on funds it had already received. Clearly the Division is not entitled to such a windfall. The Division had the use of the four officer/shareholders' money from the date they elected to have the 1998, 1999 and 2000 overpayments credited to their 1999, 2000 and 2001 estimated tax accounts, and it would be unfair and inequitable to collect interest from petitioner based on its failure to deduct and withhold these same taxes. Simply stated, the prepayment of income taxes on the officer/shareholders' wages was accomplished through estimated tax payments instead of withholding. By grossly overpaying their income taxes in 1998 and electing to apply the overpayments to each subsequent year's estimated tax account, the officer/shareholders, in essence, prepaid their income tax liabilities for 1999, 2000 and 2001 in 1998. The Division had the use of the officer/shareholders' substantial overpayments interest free since 1998 and it cannot reasonably expect to also collect interest on these same taxes from the officer/shareholders' corporation when it already had the funds in its possession well before the withholding taxes were even due.

F. The petition of FO-NA, Inc. is granted, and the three notices of deficiency dated February 18, 2003 are hereby canceled in full.

DATED: Troy, New York  
January 13, 2005

/s/ James Hoefler  
PRESIDING OFFICER